No. 16341

In the United States Court of Appeals for the Ninth Circuit

JOE L. SCHMITT, JR., AND HELEN M. SCHMITT,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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CITATIONS

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 137-162) are reported in 30 T.C. 322.

JURISDICTION

This petition for review (R. 164-168) involves federal income taxes for the taxable years 1949-1951. On September 2, 1955, the Commissioner of Internal Revenue mailed to the taxpayers a notice of deficiency in the total amount of $12,032.56. (R. 9-19.) Within ninety days thereafter and on November 25,

1955, the taxpayers[1] filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 3-19.) The decision of the Tax Court redetermining a deficiency in the total amount of $5,579.98 was entered on August 4, 1958. (R. 163.) The case is brought to this Court by a petition for review filed on October 24, 1958. (R. 168.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court properly determined that the taxpayer did not transfer all substantial rights to certain patents, with the result that the payments he received in the transactions here involved are taxable as ordinary income rather than as capital gain.

STATUTE INVOLVED

The statute involved is set out in the Appendix, *infra.*

STATEMENT

The Tax Court's findings (R. 137-152), including certain stipulated facts (R. 21-48), may be summarized as follows:

Taxpayer and his wife filed joint income tax returns for the years 1949-1951 with the Collector of Internal Revenue at Phoenix, Arizona. (R. 137.)

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[1] As used hereinafter, the term "taxpayer" refers to Joe L. Schmitt, Jr. His wife is a party to this action only because joint returns were filed for the years in question.

Since 1925 taxpayer has been engaged in accounting work in and around the city of Phoenix. In the course of his work he developed a procedure which converted single entry bookkeeping records into double entry records through the use of tabulating cards and certain machines manufactured by Remington Rand, Inc. These machines were adapted to taxpayer's needs by adding a special wiring unit which taxpayer invented and Remington Rand manufactured. The procedure developed by taxpayer has not been changed since 1947. (R. 137-138.)

Taxpayer named his procedure the "Exact-O-Matic System". During the years 1946-1949, he obtained copyrights on three different pamphlets which he had written in connection with the Exact-O-Matic System, and in 1950 he applied to the Patent Office for the registration of two service marks and designs relating to the system. These were registered in December, 1951. In the years 1948, 1949 and 1952, taxpayer also applied for three patents covering his invention. (R. 138.) Taxpayer has never applied for a copyright, trademark or patent except in connection with the Exact-O-Matic System. (R. 150.)

Taxpayer did not solicit sales of the Exact-O-Matic System, but Remington Rand publicized the system for him, and during the years 1949, 1950 and 1951, taxpayer entered into eleven substantially similar agreements whereby he transfered certain rights to territorial franchise holders called assignees. (R. 139.) The full text of one of these "Territorial Assignments" is contained in the stipulation of facts

(R. 22, 24-33), and the relevant provisions may be summarized as follows:

1. In return for consideration received, the taxpayer, as assignor, covenanted that he was "the owner of the entire right, title and interest in and to those certain United States Patents, Patents Pending, Registrations and Copyrights hereinafter referred to as 'Exact-O-Matic System'." (R. 24.)

2. The assignor granted to the assignee "the exclusive right, privilege and franchise to use and sell the said Exact-O-Matic System" throughout a described "Territorial area" during the entire term of the patents, "subject, however, to the conditions and covenants hereinafter set forth." (R. 24-25.)[2]

3. The assignee agreed to use his "best efforts to establish and/or sell" district franchises by dividing the territorial area into districts, and by granting licenses to operate the Exact-O-Matic System in those districts. The assignee was required to establish one district within thirty days to be managed by either the assignee or a corporation controlled by the assignee. Within a year, the assignee was obligated to "establish or sell a second District License, and every six months thereafter one additional District License, until a total of three District Licenses have been sold." Any sale of a district license was "sub-

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[2] The described "Territorial area" generally consisted of a single state. (R. 140.) For purposes of the agreement the term "Patent" was defined to mean "Patents, Patents pending, Registrations, Copyrights, and any oral or written agreement" made at anytime between the assignor and Remington Rand, Inc. "relating to double entry machine bookkeeping methods, procedures, and processes." (R. 25.)

ject to approval of the Assignor, insofar as the competency and financial ability and integrity of the franchise applicant is concerned." (R. 25-26.)[3]

4. The assignee agreed to use a specified contract form in granting district licenses, unless the assignor and assignee mutually agreed on a different form of contract.[4] The above provisions of paragraph three and this paragraph were "for the protection of all other Territorial Assignees and to further insure an adequate sale price to the Assignor." (R. 26-27.)

5. The assignee had the right to fix prices for the sale of all licenses within his territory, and to fix the price for the Exact-O-Matic services to be rendered by the district licensees, with the qualification that the assignee could not sell a district license for less than $3,000 without the "approval of Assignor".[5] (R. 27.)

6. The assignee agreed to collect the sales price of all district licenses, and all royalties for the use of the Exact-O-Matic System, within the territorial area. The assignee further agreed to pay to the assignor "as his share of the business transacted within the territory":

> (a) 60 per cent "of the sales price of each District License", and

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[3] The agreement also referred to the sale of "Unit A" and "Unit B" licenses which could be granted to single companies, or to an accountant with a fixed number of customers, respectively. No such licenses were ever issued. (R. 146.)

[4] A sample licensing agreement is included in the stipulation of facts. (R. 22, 34-42.)

[5] This restriction did not apply to the sale of an initial district license to a corporation controlled by the assignee.

(b) 50 per cent "of the gross royalties collected from" the territorial area, "which royalties shall not be less than ten per cent (10%) of the gross fees charged by licensees for service under said license."

The assignee agreed to pay these amounts monthly, to provide a detailed report of all receipts, to list all orders for new business within the territorial area, and to give the assignor access to assignee's books and records at all reasonable times for audit and examination. (R. 27-28.)

7. The assignee agreed to use his "best efforts and ability to promote and preserve the said business" in the territorial area, and to maintain "a uniform type of service in conformity with the standard practice and in the manner prescribed by the methods, procedures, and processes of Exact-O-Matic System." (R. 28.)

8. If the assignee failed to make the payments described in paragraph six within thirty days after they were due, the assignor had the right to terminate the agreement on thirty days' notice if the amounts due remained unpaid at the end of that period. On termination of the agreement, the assignee's interest in licenses granted to third parties would pass to the assignor and such licensees would not be terminated. (R. 28-29.)

9. The assignor agreed to arrange, without any further charge, a course of instruction for all personnel of the assignee who would be required to use the Exact-O-Matic System under the assignee's initial district license. The assignee agreed to give at least

thirty days training to the personnel who would operate the Exact-O-Matic System under all subsequent district licenses. (R. 29-30.)

10. Assignor agreed to use his best efforts with manufacturers of necessary equipment to procure the equipment for use by the assignee and licensees, within three months of the date when Remington Rand accepted the order for such equipment. (R. 30.)

11. Assignor agreed to furnish the assignee and licensees with all sample forms for use under the Exact-O-Matic System, together with a complete manual of instructions. (R. 31.)

12. Assignor agreed "to defend at his own expense any litigation arising within or without the territorial area challenging his right to use any of the aforesaid patents to the end that all rights secured to Assignee herein may be preserved." (R. 31.)

13. Assignee had the right to select his own personnel, and with the exception of the training period described in paragraph nine, assignee was to have complete dominion and control over his employees, "it being the intent and purpose of this paragraph to evidence the fact that Assignee is the territorial owner of the patent, operating completely independent[ly] of Assignor." Licensees were to have similar dominion and control over their employees. The assignee and licensees were to pay all taxes levied or assessed against them by reason of the operation of the licenses. (R. 31.)

14. The assignee had the right to grant licenses for the full term of the agreement subject to the requirements of paragraph three. (R. 31-32.)

15. The assignee agreed "not to assign or dispose of this Territorial Assignment in whole or in part without the written consent of Assignor." (R. 32.)

16. The agreement stated that time was of the essence. (R. 32.)

17. The agreement was binding on the parties' successors in interest. (R. 32.)

As previously indicated, taxpayer entered into eleven different agreements of this type during the years 1949-1951. (R. 139.) In December of 1949 taxpayer entered into an additional agreement with the Exact-O-Matic Corporation, an Arizona corporation which had 40 shares of outstanding stock. Taxpayer, his wife and a person named Weaver had always owned one share each, and in November of 1949, 37 additional shares had been issued to new stockholders, none of whom was a member of taxpayer's family. (R. 146.) The full text of the agreement between taxpayer and the corporation is contained in the stipulation of facts (R. 23, 44-48), and the relevant provisions may be summarized as follows:

1. Paragraph one states in full that the "Party of the First Part [taxpayer] is the sole owner of the entire right, title and interest in and to those certain United States Patents, Patents pending, Registrations and Copyrights referred to under that certain trade name 'Exact-O-Matic System', and that he has not mortgaged, pledged, hypothecated, or otherwise encumbered the same, or any right, title, or interest therein in any manner whatsoever." (R. 44.)

2. Subject to certain conditions hereinafter set forth, and subject further to the provisions contained in the territorial and district "franchises issued or to be issued", taxpayer granted to the corporation "the exclusive right, privilege and franchise" to use the Exact-O-Matic name, to promote the sale of territorial franchises anywhere in the world, "and to supervise the operation of said Territorial franchises already established or to be established." (R. 44-45.)

3. The corporation agreed to sell at least five territorial franchises in the United States each year until there was a franchise in each state, provided that tabulating equipment was available. (R. 45.)

4. The corporation agreed "to use its best efforts in the supervision of those Territorial franchises already established and those territorial franchises to be established". (R. 45.)

5. The corporation agreed to undertake the course of instruction which taxpayer was obligated to give under the territorial franchises. (R. 45-46.)

6. If the corporation failed to comply with the terms and provisions of the agreement, taxpayer could terminate the agreement by giving thirty days' notice. (R. 46.)

7. Taxpayer agreed to pay the corporation a specified percentage of the sales proceeds and royalties which taxpayer received from territorial franchise holders. (R. 46-47.)

8. The corporation agreed not to assign, dispose of or encumber the agreement or future proceeds from the agreement in whole or in part without first obtaining taxpayer's written consent. (R. 47.)

9. Time was of the essence. (R. 47.)

10. The agreement was binding on the parties' successors in interest. (R. 47-48.)

Taxpayer was an officer of the corporation, but he received neither salary nor royalties from the corporation, and because he was occupied with his own clients, he did not aid the corporation in furnishing Exact-O-Matic service to its clients. (R. 149.) During the year 1949, taxpayer personally trained the employees of the territorial franchise holders, but in 1950 and 1951, the corporation provided this training. (R. 151-152.)

On May 3, 1951 Remington Rand, Inc., wrote a letter to taxpayer stating that the company would not knowingly manufacture, lease or sell the wiring unit designed by taxpayer "except for franchise holders of Exactomatic Systems of Joe L. Schmitt, Jr." (R. 149-150.) Remington Rand charged taxpayer \$260 for each wiring unit manufactured for the Exact-O-Matic System. This was so whether the machine containing the wiring unit was rented or sold by Remington Rand. In the event it was rented, the wiring unit would be returned to Remington Rand with the machine at the termination of the lease. Such wiring unit belonged to taxpayer, and if the machine, together with the unit, were subsequently rented, no further charge was made by Remington Rand to taxpayer for the unit. (R. 150.)

As consideration for making the eleven territorial assignments previously described, taxpayer received

the following net amounts[6] during the years in question (R. 150-151):

1949	$ 7,962.02
1950	36,992.00
1951	10,997.00

In addition, taxpayer received the following net amounts under paragraph 6(a) of the territorial assignments (R. 151):

1949	$ 0.00
1950	7,498.00
1951	1,799.00

Finally, taxpayer received an undisclosed amount of royalties under paragraph 6(b) of the territorial assignments. These royalties were reported as ordinary income, but taxpayer reported the remainder of the above-mentioned net amounts as capital gain. (R. 151.) The Commissioner determined that the latter amounts were ordinary income and the Tax Court sustained this determination. (R. 153-161.)

SUMMARY OF ARGUMENT

Taxpayer invented a mechanical method of translating single entry bookkeeping records into double entry records, and he registered the entire process under the trade name "Exact-O-Matic System."

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[6] "Net amounts" as here used means total amounts received less certain uncontested offsets. (R. 151.) In his deficiency notice the Commissioner disallowed certain other claimed deductions (R. 152), but the Tax Court sustained the deductions (R. 161-162), and they are no longer in issue here.

After filing patent applications for his invention, he transferred certain rights to territorial franchise holders who were authorized to use the system and were obligated to issue district licenses within their territorial area. In return, taxpayer received lump sum payments from the franchise holders, a share of all amounts paid for district licenses, and royalties based on a percentage of the gross fees charged by licensees for service in each territorial area. The royalties were reported as ordinary income and are not involved in this proceeding. The issue here is whether the remaining proceeds which taxpayer received were taxable as ordinary income or as capital gain, and we submit that the Tax Court was clearly correct in deciding that the amounts involved were taxable at ordinary income rates.

In statutory terms, the issue with respect to the taxable years 1949 and 1950 is whether there was a "sale" of the Exact-O-Matic System within the meaning of Section 117(a)(4) of the Internal Revenue Code of 1939. As to the taxable year 1951, the statutory question is whether taxpayer transferred "all substantial rights" to the system within the meaning of Section 117(q) of the Code. It is clear that if taxpayer failed to transfer "all substantial rights" within the meaning of Section 117 (q), he also failed to effect a "sale" under Section 117(a)(4), with the result that all of the proceeds are taxable as ordinary income.

The record here presented clearly sustains the Tax Court's determination that taxpayer did not transfer "all substantial rights" to the Exact-O-Matic System

within each territorial area. It is axiomatic that a patent carries with it the rights to make, use and sell the invention, but instead of transferring all of these rights in the case at bar, taxpayer actually transferred only the right to use the system. The special wiring unit which was essential to the operation of the system was manufactured at taxpayer's direction, and it remained taxpayer's property. Furthermore, no territorial franchise holder or district licensee could sell or otherwise dispose of his interest in the use of the system without first obtaining taxpayer's written consent. This unrestricted control over the sale or other disposition of the system obviously constitutes the retention of a substantial right by the taxpayer, and is wholly inconsistent with the claim that all substantial rights to the system were transferred to the franchise holders.

Actually, as we have stated previously, what the franchise holders received was simply a license to use the system in a described territorial area, and even this right of use was subject to limitations. In particular, the franchise holders were obligated to sell a certain number of district licenses within a specified time on terms laid down by the taxpayer, and they were also required to furnish an essential course of training for the licensees' personnel. In addition, they were required to furnish taxpayer with a report on all new business in the area when they made payments to the taxpayer at regular monthly intervals. Finally, the franchise holders were under a general obligation to use their best efforts "to promote and preserve the said business of

each District". Had they failed to uphold any of the covenants which were basic to the development of taxpayer's system, taxpayer would have been entitled as a matter of contract law to terminate the franchise agreements.

Furthermore, the franchise agreements provided that taxpayer would defend any infringement suits at his own expense, and this reserved right, coupled with the obligation to pay the costs of litigation, is again indicative of the fact that taxpayer had not transferred all substantial rights to the System to the franchise holders. Indeed, after taxpayer had entered into some of the franchise agreements here involved, he entered into another contract with the Exact-O-Matic Corporation which was prefaced with the unequivocal declaration that taxpayer was still "the sole owner" of the "entire" Exact-O-Matic System.

Considered collectively, these factors clearly sustain the lower court's factual determination that taxpayer did not transfer all substantial rights to the system in each territorial area, and is therefore not entitled to treat the proceeds as capital gain. Each case in this area necessarily rests on its own facts, and where the record warrants the ultimate conclusion reached by the lower court, as it does here, the decision below is entitled to stand and should be affirmed.

ARGUMENT

The Tax Court Properly Determined That the Payments Taxpayer Received for Transferring Certain Patent Rights Were Taxable As Ordinary Income Rather Than As Capital Gain, Because Taxpayer Did Not Sell the Patents Within the Meaning of Section 117(a)(4) of the Internal Revenue Code of 1939 or Transfer "All Substantial Rights" to the Patents Within the Meaning of Section 117(q) of the Code

Taxpayer developed a procedure for converting single entry bookkeeping records into double entry records through the use of tabulating machines equipped with a special wiring unit which taxpayer invented. Taxpayer applied for three patents covering his invention and he registered the entire procedure under the trade name "Exact-O-Matic System". Thereafter he transferred certain rights with respect to the system to territorial franchise holders who agreed to issue district licenses within their territorial area. In return, taxpayer received a lump sum payment from each of the franchise holders, a share of the amounts paid for the various district licenses, and royalties based on a percentage of the gross fees charged by licensees for service in each territorial area. Taxpayer reported the royalties as ordinary income, and the taxation of these payments is not in issue here. The remaining payments which taxpayer received during the years 1949-1951 were reported as capital gain, and the ultimate issue here is whether these amounts were properly reported as capital gain, or were taxable as ordinary income. The Tax Court held (R. 153-161) that the amounts in question were taxable as ordinary income because

taxpayer had not transferred all substantial rights to the Exact-O-Matic System, and we submit that on the particular facts here involved, the court below was fully warranted in reaching this conclusion.

With respect to the proceeds which taxpayer received in the years 1949 and 1950, the statutory question is whether there was a "sale or exchange" of the Exact-O-Matic System within the meaning of Section 117(a)(4) of the Internal Revenue Code of 1939 (Appendix, *infra*). With respect to the year 1951, the issue in statutory terms is whether taxpayer transferred "all substantial rights" to the system within the meaning of Section 117(q) of the Code (Appendix, *infra*) which governs the taxation of proceeds received in taxable years beginning after May 31, 1950.[7] While Section 117(q) eliminates some of the requirements for capital gain treatment which existed under Section 117(a)(4), Congress did not intend to change the basic requirement that there be a "sale or exchange" of the property. The Senate Committee Report with respect to the provisions appearing in Section 117(q) states:[8]

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[7] For purposes of this case it is immaterial that the transfers occurred before taxpayer had obtained a patent on his invention (see R. 78-79, 138), because Section 117 can apply where an inventor sells his interest in the invention either before or after obtaining a patent. *Speicher* v. *Commissioner*, 28 T.C. 938. See *Philbrick* v. *Commissioner*, 27 T.C. 346, 356.

[8] S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439-440 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5081, 5083). This report was actually issued in connection with Section 1235 of the 1954 Code, but it is relevant here since Section 117(q)

The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments * * *. To illustrate, exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be "sales or exchanges" because, in substantive effect, all "right, title, and interest" in the patent property is transferred (irrespective of the location of legal title or other formalities of language contained in the license agreement). Moreover, the courts have recognized that an exclusive license agreement in some instances may constitute a sale for tax purposes even where the right to "use" the invention has not been conveyed to the licensee, if it is shown that such failure did not represent the retention of a substantial right under the patent by the licensor. It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones. The word "title"

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was enacted in 1956, after the adoption of Section 1235, for the purpose of making the provisions of Section 1235 retroactive to 1950. S. Rep. No. 1941, 84th Cong., 2d Sess., p. 5 (1956-2 Cum. Bull. 1227, 1229).

> is not employed because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor.

Thus the requirement that "all substantial rights" be transferred is really a continuation of the former requirement that there be a "sale or exchange" of the property; and under both Section 117(a)(4) and Section 117(q), "the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee".

On the record here presented, the Tax Court was clearly warranted in finding that taxpayer did not transfer "all substantial rights" to the Exact-O-Matic System. It is axiomatic that a patent carries with it the exclusive right to make, use and sell the invention. See *Waterman* v. *Mackenzie*, 138 U.S. 252; *Broderick* v. *Neale*, 201 F. 2d 621 (C.A. 10th); *United States* v. *Carruthers*, 219 F. 2d 21 (C.A. 9th). However, instead of transferring all of those rights with respect to the Exact-O-Matic System, taxpayer actually transferred only the right to use the system. The wiring unit which was essential to the operation of the system was manufactured at taxpayer's direction, and it remained taxpayer's property. (R. 66-67, 121-122, 150.) Furthermore, taxpayer retained a veto power which made it impossible for any transferee to sell or dispose of his interest in the use of the Exact-O-Matic System without taxpayer's

written consent. (R. 32, 38, 157, 158.) See *Watkins* v. *United States*, 252 F. 2d 722, 725 (C.A. 2d). In other words, taxpayer's assertion (Br. 10) that he transferred the right "to make, use and sell" the system is simply not true, because the transferees had no control over the manufacture of the vital wiring unit, and they had no power to sell their interest in the use of the system unless taxpayer consented. Actually, as we have previously stated, what they received from taxpayer was simply a license to use the system, and even this right was subject to numerous limitations.

The contracts which gave the territorial franchise holders authority to use the Exact-O-Matic System were expressly made subject "to the conditions and covenants hereinafter set forth". (R. 25.) In particular, the franchise holders agreed to sell a certain number of district licenses within a specified time on terms laid down by the taxpayer. (R. 25-27, 32.) They also agreed to furnish an essential course of training for the licensees' personnel (R. 30), and finally, they agreed to use their best efforts "to promote and preserve the said business of each District" (R. 28). Had the franchise holders failed to uphold any of these covenants, which were basic to the development of taxpayer's system, taxpayer would have been entitled as a matter of contract law to rescind the entire agreement. See, e.g., *Oscar Barnett Foundry Co.* v. *Crowe*, 219 Fed. 450, 455 (C.A. 3d); *Ruby* v. *Ebsary Gypsum Co.*, 36 F. 2d 244, 246 (W.D N.Y.). In addition, it was expressly provided that taxpayer could terminate the agreement on thirty

days' notice if the franchise holder failed to pay over a specified share of all proceeds from the sale of district licenses and all fees collected from customers throughout the territorial area. (R. 28-29.) See *Six Wheel Corp.* v. *Sterling Motor Truck Co.*, 50 F. 2d 568, 573 (C.A. 9th). In short, the territorial franchise holders had the right to use the System only so long as they complied with taxpayer's requirements concerning further development of the business and prompt payment of the proceeds.

The various factors discussed thus far would, in themselves, sustain the Tax Court's decision that the transfer from taxpayer to each of the franchise holders was a license, rather than an assignment of all substantial rights in the Exact-O-Matic System. In *Bailey* v. *Commissioner*, decided October 10, 1950 (1950 P-H T.C. Memorandum Decisions, par. 50-237, affirmed, 188 F. 2d 360 (C.A. 3d), the taxpayer granted to an independent company, much more broadly than is the situation in the instant case, the sole and exclusive right "to make, use and sell" certain inventions. However, the company was required to obtain the taxpayer's written consent before assigning any of the transferred rights, and the agreement could be terminated on sixty days' notice if the company failed to develop taxpayer's designs or conducted the business improperly. Basing its decision on the fact that the taxpayer had reserved these rights, the Tax Court concluded that the transaction was in reality a license, rather than an assignment or "sale" of the taxpayer's interest in the patented property. The Tax Court reached this conclusion, and the

Court of Appeals affirmed, even though the agreement provided that the company would prosecute or defend any infringement suits at its own expense.

Here, the evidence indicative of a license is even stronger, because in addition to the transfer being limited to the mere use of the system, and in addition to the taxpayer retaining an absolute veto power over future transfers and a right to terminate the agreement for breech of certain covenants, taxpayer also retained the right to defend all patent infringement suits and agreed to pay the costs of such litigation. The retention of such a right, coupled with the obligation to pay the costs of litigation, is clearly pursuasive evidence that the transferor has retained a substantial proprietary interest in the transferred property. *Watkins* v. *United States*, 252 F. 2d 722, 725 (C.A. 2d); *Switzer* v. *Commissioner*, 226 F. 2d 329, 331 (C.A. 6th). See also *E. W. Bliss Co.* v. *United States*, 253 U. S. 187, 192-193. Indeed, the franchise contracts in the case at bar make it unequivocally clear that taxpayer retained such an interest. Taxpayer agreed (R. 31) "to defend at his own expense any litigation arising within or without the territorial area challenging *his right* to use any of the aforesaid patents to the end that all rights secured to Assignee herein may be preserved." (Emphasis added.) See *Switzer* v. *Commissioner*, 226 F. 2d 329, 330 (C.A. 6th).

Taxpayer's assertion (Br. 9-10) that he transferred "all substantial rights" to the Exact-O-Matic System within the areas covered by the territorial assignments is inconsistent not only with the above facts,

but also with the provisions of the related contract which taxpayer entered into with the Exact-O-Matic Corporation in December, 1949. (R. 95-96, 146.) In two different paragraphs of that contract, there is an express reference to the territorial franchises "already established or to be established." (R. 45.) Yet, the opening paragraph of the contract with the corporation (R. 44) states that taxpayer "*is the sole owner* of the *entire* right, title and interest in and to those certain United States Patents, Patents pending, Registrations and Copyrights referred to under that certain trade name 'Exact-O-Matic System' * * *." (Emphasis added.) Manifestly, taxpayer could not and would not have made this unequivocal declaration if the prior territorial franchise agreements had been intended to divest him of his ownership rights in the Exact-O-Matic System. In effect, the corporate contract represents taxpayer's *own* statement that he was "the sole owner" of the "entire" Exact-O-Matic System, notwithstanding the agreements which he had previously made with territorial franchise holders. The conclusion is inescapable that the franchise agreements were simply licenses, not an assignment of taxpayer's ownership interest. *Eterpen Financiera Sociedad* v. *United States*, 108 F. Supp. 100, 104-105 (C. Cls.), certiorari denied, 346 U.S. 813.

In the *Eterpen* case, the taxpayer entered into an agreement with two different companies granting them the exclusive right "to make, use and sell" certain devices during the full life of the taxpayer's patents, subject to certain conditions. The taxpayer contended that this so-called license agreement act-

ually constituted an assignment or "sale" of the patents for tax purposes. In rejecting this contention, the Court of Claims relied primarily on the terms of an option agreement which the taxpayer had executed at the same time as the licensing agreement. The court stated (pp. 104-105):

> When these two instruments are considered together, they negative in clear and unmistakable terms the contention by the taxpayer that it intended to effect a sale of the patents by means of the license agreement alone. In the option agreement the taxpayer expressly warranted that it was "sole and exclusive owner of the entire right, title, and interest in and to all of the patents," and that it had "the full right and power to assign and transfer the same." But if the taxpayer's present theory with respect to the license agreement were adopted, these words in the option agreement become meaningless, and the option agreement itself worthless because the taxpayer would have had nothing left to convey to Eversharp upon the exercise of the option on December 1, 1946. It is highly improbable and illogical that such a result was intended by the taxpayer when these agreements were drafted.

Precisely the same reasoning is applicable in the case at bar, because taxpayer's contract with the Exact-O-Matic corporation would have been meaningless if taxpayer had already surrendered all of his substantial rights to the system in the areas where territorial franchises had been issued.

After making a careful analysis of the territorial franchise agreements and the contracts which the

franchise holders were required to use in granting district licenses the court below concluded that the rights retained by taxpayer and the limitations imposed on the transferees were incompatible with the contention that all substantial rights to the Exact-O-Matic System had been surrendered by the taxpayer within the area of the territorial franchises. (R. 156-160.) The limitations on the transferees are listed in detail in the court's opinion (R. 157-159) and the interests retained by the taxpayer have already been discussed at length. To summarize, taxpayer retained ownership of the wiring unit which was essential to the operation of the system; he retained the power to veto any proposed sale or other disposition of the interest held by the franchise holders and the district licensees; he could terminate the territorial franchise agreements for breach of certain covenants relating to future development of the business and the payment of royalties; he could defend "his right" to use the patents and was obligated to pay for the defense of all infringement suits; and after some of the franchises in question had already been created, taxpayer entered into another contract on the premise that he was still "the sole owner" of the "entire" Exact-O-Matic System. Considered collectively, these factors clearly sustain the Tax Court's decision that taxpayer did not dispose of all substantial rights to the Exact-O-Matic System in each territorial area. *Watkins* v. *United States*, 252 F. 2d 722, 725 (C.A. 2d); *Bailey* v. *Commissioner*, decided October 10, 1950 (1950 P-H T.C. Memorandum Decisions, par. 50,237), affirmed, 188 F. 2d 360 (C.A. 3d); *Switzer* v. *Commissioner*,

226 F. 2d 329 (C.A. 6th); *Eterpen Financiera Sociedad* v. *United States*, 108 F. Supp. 100, 104-105 (C. Cls.), certiorari denied, 346 U.S. 813; *Broderick* v. *Neale*, 201 F. 2d 621 (C.A. 10th). See also *Six Wheel Corp.* v. *Sterling Motor Truck Co.*, 50 F. 2d 568, 572-573 (C.A. 9th).

Taxpayer seeks to minimize the rights he reserved by contending (Br. 11-15) that they were designed "to protect the value of the system" (Br. 11) and "to see that the system did not fall into the hands of persons unqualified to use it" (Br. 15). However, it makes no difference why taxpayer retained certain rights, because the controlling fact is that he *did* retain them, and having chosen to do so, he is subject to the ordinary income tax rates which apply where a patent owner makes a transfer without surrendering all substantial rights in the property. (See R. 161.) Indeed, taxpayer recognized that part of the income he derived from the franchise agreements was taxable at ordinary income rates when he reported his royalty payments as ordinary income. See *Switzer* v. *Commissioner*, 226 F. 2d 329, 333 (C.A. 6th). At no point during these proceedings has he suggested that this was incorrect, or offered any reason for treating the lump sum payments differently, and we submit that the lump sum payments stand on the same footing tax-wise as the continuing royalty payments, and are likewise taxable as ordinary income.

Each case in this area necessarily turns on its own facts and in view of the variations in the evidentiary content of such cases, differences of result are not only inevitable, but appropriate. Taxpayer has cited

a number of cases (Br. 11-20) where the presence of one or more of the factors here involved did not preclude capital gain treatment, but taxpayer has cited no case, and we know of none, where preferential capital gain treatment was accorded in a situation involving a combination of all of the important factors present here. In deciding this case, the court below rested its decision not on any one factor, but on (R. 160-161) "all of the rights, powers, and continuing interests reserved by petitioner, taken in combination", and we submit that the conclusion which the court reached on the particular facts of this case, considered in their totality, is correct and entitled to stand. See *Watkins* v. *United States*, 149 F. Supp. 718 (Conn.), affirmed, 252 F. 2d 722 (C.A. 2d). Cf. *Stockton Harbor Indus. Co.* v. *Commissioner*, 216 F. 2d 638, 640, 650-651, 656 (C.A. 9th), certiorari denied, 349 U.S. 904.

CONCLUSION

The decision below is correct and should be affirmed.

Respectfully submitted,

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June, 1959

APPENDIX

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) * * *

* * * *

(4) [As amended by Sec. 150(a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * *

(q) [As added by Sec. 1 of the Act of June 29, 1956, c. 464, 70 Stat. 404] *Transfer of Patent Rights.*—

(1) *General rule.* — A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

(2) *"Holder" defined.*—For purposes of this subsection, the term "holder" means—

(A) any individual whose efforts created such property, or

* * * *

(4) *Applicability.*—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred.

(26 U.S.C. 1952 ed., Sec. 117.)

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